No. 14822

In the United States Court of Appeals for the Ninth Circuit

BLUMENFELD ENTERPRISES, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

CHARLES K. RICE,
Acting Assistant Attorney General.
LEE A. JACKSON,
DAVID O. WALTER,
Attorneys,
Department of Justice,
Washington 25, D. C.

FILED
FEB 24 1956
PAUL P. O'BRIEN, CLERK

INDEX

	Page
Opinion below	1
Jurisdiction	1
Question presented	2
Statute and regulations involved	2
Statement	3
Summary of argument	10
Argument:	
I. Taxpayer sustained no loss uncompensated for by insurance or otherwise on the demolition of its building	11
II. The Tax Court's reasons for holding that taxpayer sustained no loss are sound	14
A. The fact that the term of a lease is longer than the expected useful life of a building is relevant in determining whether taxpayer has sustained a loss	15
B. If the demolition occurred as part of a sale, there is no loss apart from gain or loss on the entire transaction	16
C. The building was in fact demolished in connection with securing a lease	17
Conclusion	20

CITATIONS

Cases:

Anahma Realty Corp. v. *Commissioner,* 42 F. 2d 128, certiorari denied, 282 U. S. 854	13
Berger v. *Commissioner,* 7 T. C. 1339	13
Camp Wolters Land Co. v. *Commissioner,* 160 F. 2d 84	13
Commissioner v. *Appleby's Estate,* 123 F. 2d 700	13
Commissioner v. *Moore,* 207 F. 2d 265	15
Commissioner v. *Pearson,* 188 F. 2d 72	15
Commissioner v. *Providence, W. & B. R. Co.,* 74 F. 2d 714	17
Continental Illinois Nat. B. & T. Co. v. *United States,* 18 F. Supp. 229	13
Dayton Co. v. *Commissioner,* 90 F. 2d 767	13
Eaton v. *Commissioner,* 81 F. 2d 332, on second appeal, 95 F. 2d 628	12
Helvering v. *Gordon,* 134 F. 2d 685	11
Hotel McAllister v. *United States,* 3 F. Supp. 533	11
Ingle v. *Gage,* 52 F. 2d 738	13
Lamson Bldg. Co. v. *Commissioner,* 141 F. 2d 408	15
Mississippi River & Bonne Terre Railway v. *Commissioner,* 39 B.T.A. 995	17

Cases—Continued

Page

Parma Co. v. *Commisssioner,* 18 B.T.A. 429 11
Providence Journal Co. v. *Broderick,* 104 F. 2d 614 12
Smith Real Estate Co. v. *Page,* 67 F. 2d 462 19
Spinks Realty Co. v. *Burnet,* 62 F. 2d 860, certiorari denied, 290 U.S. 636 13
Terre Haute Electric Co. v. *Commissioner,* 96 F. 2d 383 17
Union Bed & Spring Co. v. *Commissioner,* 39 F. 2d 383 11
Young v. *Commissioner,* 59 F. 2d 691, certiorari denied, 287 U. S. 652 .... 12, 13

Statute:

Internal Revenue Code of 1939, Sec. 23 (26 U.S.C. 1952 ed., Sec. 23) 2

Miscellaneous:

Treasury Regulations 111, Sec. 29.23(e)-2 .... 2, 12

In the United States Court of Appeals for the Ninth Circuit

No. 14822

Blumenfeld Enterprises, Inc., petitioner

v.

Commissioner of Internal Revenue, respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 85-99) are reported at 23 T. C. 665.

JURISDICTION

This petition for review (R. 100-101) involves income taxes for taxpayer's taxable year ended July 31, 1948, in the amount of $31,405.31. On December 12, 1951, the Commissioner of Internal Revenue mailed to taxpayer a notice of deficiency in the amount of $31,710.66. (R. 8-12.) On February 25, 1952 (R. 1), taxpayer filed a timely petition with the Tax Court for a redetermination of that deficiency under the provisions of Section

272 of the Internal Revenue Code of 1939, and on March 16, 1954 (R. 2), filed an amended petition for such redetermination (R. 4-8). The decision of the Tax Court sustaining a deficiency of $31,405.31 was entered on March 23, 1955. (R. 99.) The case is brought to this Court by petition for review filed June 15, 1955. (R. 100-101.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court erred in determining that taxpayer did not sustain a loss on the voluntary demolition of its theatre building in 1950 under Section 23(f) of the Internal Revenue Code of 1939.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

*   *   *   *   *

(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

*   *   *   *   *

(26 U. S. C. 1952 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.23(e)-2. *Voluntary Removal of Buildings.*—Loss due to the voluntary removal or demo-

lition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements is deductible from gross income. When a taxpayer buys real estate upon which is located a building, which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building.

STATEMENT

The facts, as stipulated, as developed by taxpayer's witnesses, and as found by the Tax Court, may be summarized as follows (R. 86-93):

Taxpayer owns and operates theatres and other businesses. On or about March 10, 1946, taxpayer purchased the fee interest in the so-called Tivoli property in San Francisco, which consisted of two adjacent, but separate, buildings. One of the buildings was known as the Tivoli Theatre Building, and the other as the Tivoli Office Building. The Theatre Building was constructed in 1911. It had once been an opera house and a famous theatrical landmark in San Francisco. When taxpayer acquired the property in 1946 that building had a remaining useful life of twenty years. During the period from February 10, 1946, to March 2, 1946, the Theatre Building was used for legitimate stage performances. From March 30, 1946, to June 2, 1947, it was used for the presentation of motion pictures. By 1947, the district in which the theatre was located was

no longer a desirable theatrical district; there were many bars in the area, and it had become a "tenderloin" district. Its location was away from the main theatre and entertainment districts. From June 2, 1947, until October 6, 1949, the theatre was closed except for one three-day period in 1948 when it was rented for an outside theatrical showing. Taxpayer had closed the theatre in 1947 because it was losing money on the operation and found it economically impractical to keep it running. Taxpayer thereafter had no intention of using the property as a theatre again. (R. 86-87.)

The Tivoli Office Building from the date of its acquisition by taxpayer has been used as an office building, and a portion of the ground floor has been occupied by a cocktail lounge and bar. (R. 87.)

Shortly prior to October 6, 1949, taxpayer had negotiations with representatives of a prospective lessee of the Theatre Building, looking towards the conversion of the building for garage and parking purposes. (R. 87.) Those representatives were Herman Hertz, a brother-in-law of the lessee (R. 129, 132) and M. L. Rose, a real estate broker (R. 137). The negotiations were for the specific purpose of converting the building into a five-story garage on the assumption by the lessee that the cost would be between $45,000 and $50,000. (R. 114, 134, 137.) As a result of these negotiations, taxpayer, on October 6, 1949, as lessor, and Harry Morofsky, as lessee, executed a lease of the Theatre Building for a term of twenty-five years and an aggregate rental of $420,000; in addition, the lessee agreed to pay all real estate taxes and charges levied against the property. Although the term of the lease was to start May 1, 1950, the lessee was allowed to enter immediately for the purpose of beginning the necessary alterations. The speci-

fied rental was to be paid at the rate of $1,250 per month for the first ten years, and $1,500 per month for the last fifteen years. (R. 87-88.) Performance of the conditions of the lease by the lessee for two years was guaranteed by Herman Hertz, the guarantee being limited to a total of $10,000. (R. 50-51.) The lease specifically limited the use of the property for the purpose of conducting the following business (R. 88):

> A garage and storage and offices for the use of the Lessee in connection with garage operations, or concessions under-let hereunder to be used with office space, as hereinafter provided.

In the lease Morofsky, the lessee, specifically undertook to remodel the building so as to make it suitable for conducting a garage and car storage business with such offices as might be necessary for the conduct of the business. For this purpose taxpayer, as lessor, granted the lessee authority to construct as many floors as the lessee might find necessary but the lessee was obligated as a minimum to construct a basement floor and a first and second floor above that. (R. 88.)

Under the lease the lessee was required to submit to taxpayer for its approval plans for the remodeling of the building. In the latter part of 1949, preliminary and final plans for a five-story garage were prepared by the lessee at an expense of approximately $4,000, and were approved by taxpayer. (R. 88.)

At the time the lease was entered into on October 6, 1949, neither taxpayer nor the lessee had any intention of demolishing the Theatre Building. (R. 88-89.)

In November 1949, the lessee submitted to the proper authorities of the City and County of San Francisco

his plans for remodeling the Tivoli Theatre Building so as to convert the building to a five-story parking garage. The city and county authorities declined to approve the plans as submitted and insisted upon costly revisions involving a substantial increase in the thickness of the walls by the addition of concrete, the inclusion of additional supporting members, and changes in the plans for the ramps, all of such a nature as to reduce substantially the amount and convenient usability of floor space for parking purposes and to render it economically unfeasible to use the Theatre Building for the purpose of a parking garage. (R. 89.)

The estimated cost of the remodeling, if performed in accordance with the plans required by the City and County of San Francisco, was in excess of $125,000. It was not economically feasible to incur such cost, and the plan for remodeling the Theatre Building for purposes of a parking and storage garage therefore had to be abandoned. (R. 89.)

After the defeat of plan for remodeling the building, the lessee consulted another engineer who advised that the Theatre Building be demolished and that the area thus released be used for surface parking. (R. 89.)

On April 24, 1950, the lessor and lessee entered into a letter agreement looking towards the purchase of the entire Tivoli property by the lessee, and providing in any event for permission to the lessee to demolish the Theatre Building. (R. 89-90) That agreement reads in part as follows (R. 52-54, 90-91):

1. The sale price is to be $350,000.00.
2. The sum of $25,000.00 is to accompany the

sale agreement, in consideration for which the Purchaser shall have an option to conclude the deal within one (1) year.

*   *   *   *   *

5. In the event the Purchaser does not conclude the purchase of the property within one (1) year, the $25,000.00 mentioned under No. 2 above shall remain with the Seller as additional lease deposit under that certain lease dated the 6th day of October, 1949, between Blumenfeld Enterprises, Inc., as lessors, and Harry Morofsky, as lessee, and shall be deducted from rentals at the end of the lease term. In consideration of this additional lease deposit, the lessors grant to the lessee permission to demolish the rear portion of the premises [Theatre Building] for the purposes conforming to said lease and further provided the lessee shall furnish to the lessor modified plans showing the proposed basement and ground floor development and shall secure from the lessors written permission for said development. All of the cost of demolishing and improving shall be at the lessee's sole cost and expense.

6. The Seller, as the lessor, expressly retains all of their rights under the aforementioned lease dated October 6, 1949, and makes no waiver of any of the conditions of said lease, including but not limited to the $10,000 guarantee by Mr. Herman Hertz.

7. In the event the Purchaser exercises his option to purchase within the one (1) year period,

> then he shall be given credit by the Seller for the net gross profit from the operation of all of the premises in the interim period. The Seller shall deduct from said rentals, taxes, insurance, utility costs and all other legitimate items of expense.

The letter agreement also contained a statement that it sets forth only the "basic agreement" and that both parties would thereafter execute a "formal sales agreement." The $25,000 payment, referred to in paragraph "2" above, was in fact made on May 1, 1950. When the letter agreement of April 24, 1950, was entered into, the lessee had not determined whether he would exercise the option to purchase which was given therein. (R. 91.)

The "formal" agreement contemplated by the parties was executed on February 23, 1951. By its terms the time for exercise of the lessee's option was extended to expire on October 1, 1951, and the lessee was expressly required, notwithstanding anything in the lease of October 6, 1949, to the contrary, to clear the portion of the property formerly occupied by the theatre. The lessee was also expressly authorized to use the "premises and area for parking lot purposes by erecting a ramp for ingress and egress therefrom through the old entrance to the Tivoli Theatre." Pursuant to permission granted by the lessor in paragraph "5" of the letter agreement of April 24, 1950, the lessee had already demolished the Theatre Building on or about May 1, 1950 prior to the end of taxpayer's fiscal year ended July 31, 1950. (R. 91.)

There was at no time any understanding or plan, either by the taxpayer or the lessee, to construct a

new building on the theatre property, and no building has ever been constructed thereon. (R. 92.)

On September 27, 1951, Harry Morofsky exercised the option granted by the agreements of April 24, 1950, and February 23, 1951, to purchase the Tivoli property, and on November 7, 1951, assigned his rights thereunder to the Hertz Shoe Clinic, Inc., a corporation. That corporation is now the owner of the Tivoli property. (R. 92.)

Taxpayer has claimed in its returns, and the Commissioner has allowed, depreciation on the Tivoli Theatre and Office Buildings on the basis of a remaining life of twenty years from the date of its acquisition of the fee interest therein (March 10, 1946). (R. 92.)

In its income tax return for its fiscal year ended July 31, 1950 taxpayer claimed as a deduction an abandonment loss on the demolition of the Tivoli Theatre Building in the amount of $154,226.34 [1] representing the undepreciated balance of the cost of that building, as shown on taxpayer's books, resulting in a net operating loss of $82,818.32 for its fiscal year ended July 31, 1950. Taxpayer claimed a net operating loss carry-back of $82,818.32 from its fiscal year ended July 31, 1950, to its fiscal year ended July 31, 1948, and made application for a tentative carry-back adjustment under Section 3780 of the Internal Revenue Code of 1939. A tentative allowance was made to taxpayer under this section in the amount of $30,803.55. (R. 92-93.)

---

[1] It is stipulated that the total unrecovered cost of the Theatre Building and improvements was $132,284.42.

In his determination of taxpayer's deficiency for the fiscal year ended July 31, 1950, the Commissioner disallowed the deduction claimed upon the demolition of the Tivoli Theatre Building, and in his notice of deficiency to taxpayer for its fiscal year ended July 31, 1948, has not allowed the net operating loss deduction claimed by taxpayer. (R. 93.)

SUMMARY OF ARGUMENT

Under Section 23(f) of the Internal Revenue Code of 1939, corporations are allowed deductions from taxable income for losses "sustained during the taxable year" and not compensated for by insurance "or otherwise." It is well settled that no such loss is sustained by the owner when a building is demolished by him or by the lessee in connection with obtaining a lease of the property.

Instead the unrecovered cost of the building is regarded as an expense of securing the lease, to be amortized, like other such expenses, over the term of the lease. Although the owner may no longer have the building, the lease itself is regarded as compensation or as a substitution of a new asset for the old.

The facts in the present case may be considered from several angles. If the original lease agreement of October 6, 1949, be considered as remaining in full force, then there was no loss to taxpayer on demolition of the building, the obligations of the lessee continuing undiminished, and the lease having a longer term than the estimated useful life of the building. Taxpayer would have received no asset at the end of the lease. If the agreement of April 24, 1950, is regarded as part of a sale agreement, the unrecovered cost of the building is merely to be considered a part of the

basis for determining gain or loss when the sale was consummated.

The facts of this case, however, most reasonably fall into the pattern of a lease agreement made in its final form on April 24, 1950. So viewed, they clearly call into play the principle that the demolition of the building was in exchange for the acquisition of that lease and that accordingly no loss was sustained.

ARGUMENT

I

Taxpayer Sustained No Loss Uncompensated for by Insurance or Otherwise on the Demolition of Its Building

Under Section 23(f) of the Internal Revenue Code *(supra)*, corporations are allowed deductions from taxable income for losses "sustained during the taxable year" and not compensated for by insurance "or otherwise." Included in such losses, provided they are in fact sustained during the year and are not compensated for, are losses due to the demolition of buildings. *Union Bed & Spring Co.* v. *Commissioner,* 39 F. 2d 383 (C.A. 7th); *Helvering* v. *Gordon,* 134 F. 2d 685 (C.A. 4th); *Hotel McAllister* v. *United States,* 3 F. Supp. 533 (S.D. Fla.); *Parma Co.* v. *Commissioner,* 18 B.T.A. 429.

Where there has been an accidental destruction of buildings, there is usually no question that a loss has been sustained. Where, however, there is a voluntary demolition of a building, it is necessary to look into the surrounding circumstances more closely to determine whether a loss has actually been sustained and if so, whether it has been compensated for.

For example, if a purchaser of improved property razes the building for the purpose of erecting a new

building, he has sustained no loss by the razing of the old building. The cost of razing is a part of the cost of preparing the site of the new building, and, as is done by Section 29.23(e)-2 of Treasury Regulation 111, *supra*, it may be assumed that he paid less for the real estate because of the need to get rid of the building which was worthless for his purposes. The fact that the building may have had some value for other purposes, or that it may have had an unrecovered basis for tax purposes does not mean that a loss has been sustained, and does not justify isolating the destruction of the building from the entire context of the transaction for tax purposes.[2] *Providence Journal Co.* v. *Broderick,* 104 F. 2d 614 (C.A. 1st). Closely similar is the situation where the purchaser of an orchard unsuccessfully claims a deduction for the destruction of apple and pear trees, when his intention at the time of purchase is to clear the land for the growing of lettuce. *Eaton* v. *Commissioner,* 81 F. 2d 332, on second appeal, 95 F. 2d 628 (C.A. 9th).

Similarly, where the demolition is voluntary and in connection with a lease, the entire transaction must be looked at to determine whether a loss has in fact been realized and whether there has been compensation for the loss. It has long been settled that where the owner demolishes buildings in order to lease land to a tenant who is to erect new buildings, there is no uncompensated loss. The owners, far from sustaining a loss, have "added to their assets, or substituted property for another form of capital assets." *Young* v. *Commis-*

---

[2] As taxpayer correctly points out (Br. 13-14), the present case is not one where the purchaser is claiming a loss. The foregoing example is merely illustrative of the general principle.

sioner, 59 F. 2d 691, 692 (C.A. 9th), certiorari denied, 287 U.S. 652.[3] The lease is a compensating value for the loss of the building, or "a substitution of assets rather than a loss." *Anahma Realty Corp.* v. *Commissioner*, 42 F. 2d 128, 130 (C.A. 2d), certiorari denied, 282 U.S. 854. See also *Spinks Realty Co.* v. *Burnet*, 62 F. 2d 860 (C.A. D.C.), certiorari denied, 290 U.S. 636; *Continental Illinois Nat. B. & T. Co.* v. *United States*, 18 F. Supp. 229 (C. Cls.); *Camp Wolters Land Co.* v. *Commissioner*, 160 F. 2d 84, 88 (C.A. 5th).

In the usual case the demolition is in order to clear the way for erection of a new building, but the principle is not limited to that situation. The controlling factor is the use to be made of the land by the tenant. In *Berger* v. *Commissioner*, 7 T.C. 1339, the buildings were razed in order to lease the land for a parking lot. In *Camp Wolters Land Co.* v. *Commissioner*, *supra*, the lessor bought houses and demolished them because they were in the line of a proposed firing range and the demolition was necessary in order to get a lessee, the Army, for the camp. In the *Eaton* case, *supra*, if the owner had destroyed an orchard in order to lease the land to a lettuce grower, it is clear that the cost would have been an expense of obtaining the lease. See also *Ingle* v. *Gage*, 52 F. 2d 738, 741 (W.D. N.Y.), where the court stated that a loss would not be allowed if, after demolition, the parcel could be used so as to be productive of greater gains or profits to the taxpayer. In *Dayton Co.* v. *Commissioner*, 90 F. 2d 767, 768 (C.A. 8th), in holding that there was a loss, the court pointed

---

[3] This may be true even in a case where there is no lease, and the owner merely substitutes new buildings for old. *Commissioner* v. *Appleby's Estate*, 123 F. 2d 700, 702 (C. A. 2d).

out that the demolition was not in pursuance of any plan to replace or renew the structure "or to further use the property."

So here, the building was demolished so that the land could be put to a more productive use. It is obvious that at the present time land in cities may often be more productively and profitably used as parking lots than as the site of a building. In this very case it is undisputed that the building was not productive as a theatre building, and, significantly, the parties did not contemplate its replacement by another building. If we look solely to the demolition of the building, we see, as taxpayer would have us (Br. 40-41), that before the demolition taxpayer had a building, and after the demolition, taxpayer had no building. If we look at the context, however, we see that by the entire transaction taxpayer had substituted for one form of property another of greater value.

II

The Tax Court's Reasons for Holding that Taxpayer Sustained No Loss Are Sound

We do not believe that taxpayer will seriously contest the accuracy of the foregoing statement of the principles applicable to losses claimed on the voluntary demolition of buildings. Taxpayer rather is contesting the applicability of those principles to the factual situation here involved.

Taxpayer's principal argument (Br. 24-27), that these principles do not apply here, is based on a construction of the lease as being the agreement entered into on October 6, 1949, and upon a total disregard of the modification of April 24, 1950, a view which is wholly

unwarranted by the facts of this case. This question is discussed in Part C, below. For convenience, however, we discuss taxpayer's other contentions in the same order as in taxpayer's brief.

A. *The fact that the term of a lease is longer than the expected useful life of a building is relevant in determining whether taxpayer has sustained a loss*

If we look solely to the original lease and assume that it retained its value to taxpayer even after conversion of the building to a parking garage became impossible, as taxpayer would have us do on another point (Br. 25-26), then the court below was correct in pointing out that on the demolition of the building taxpayer sustained no loss which was uncompensated (R. 97-97). Since the building had a useful life of less than sixteen years, and the property was subject to a twenty-five year lease, there could be no loss to taxpayer on the building's demolition. See *Commissioner* v. *Moore,* 207 F. 2d 265 (C. A. 9th); *Commissioner* v. *Pearson,* 188 F. 2d 72 (C. A. 5th). If, to the contrary, the useful life of the building had extended beyond the term of the lease, then there might have been a value not compensated for by the lease, which would be lost on demolition of the building.[4] As it was, however, the remaining life of the building was compensated for by the lease payments, which were not to be diminished by removal of the building. Taxpayer was no worse off after the removal than before.

---

[4] Taxpayer (Br. 18-19) cites *Lamson Bldg. Co.* v. *Commissioner,* 141 F. 2d 408 (C. A. 6th), to support the view that the cost is to be depreciated over the life of the building rather than amortized over the term of the lease. But to the contrary are *Young* v. *Commissioner, supra; Spinks Realty Co.* v. *Burnet, supra; Continental Illinois Nat. B. & T. Co.* v. *United States, supra.*

B. *If the demolition occurred as part of a sale, there is no loss apart from gain or loss on the entire transaction*

The agreement of April 24, 1950, was in effect both a lease and an option to sell. If it is regarded as the latter, then the permission to demolish the building and its immediate demolition, were part of a sale, and the basis of the building is part of the basis of the entire property, with gain or loss to be determined, as the court below pointed out (R. 97) on the basis of the entire sale price, to be reported in the year in which the sale took place.

Taxpayer's criticism of this alternative holding is (Br. 23) that the demolition of the building was a transaction independent of the option to purchase. Here again, taxpayer is asserting a rule that demolition of buildings gives rise to a tax loss in disregard of all the circumstances, and without reaching the question whether in fact a loss was sustained. Taxpayer is insisting that the only operative event was the lease agreement of October 6, 1949, that all subsequent events and agreements should be disregarded, and that if the building was not demolished in order to obtain that particular agreement, there was a loss sustained.

The weakness of that position is that the demolition did not stand alone, based on a decision by taxpayer that the building had become worthless in that taxable year. To the contrary the demolition arose in connection with negotiations between taxpayer and the lessee looking to either a continuance of the lease or a sale. The decision to demolish the building may well have been an independent event, in the sense that it was not contemplated in October, 1949, when the lease was first entered into. It was not independent of the relationship between tax-

payer and lessee as marked by the letter agreement of April 24, 1950, the formal agreement of February 23, 1951, and the final sale of September 27, 1951.

C. *The building was in fact demolished in connection with securing a lease*

Taxpayer's argument that the demolition did not occur in connection with obtaining a lease (Br. 24-37) is premised on the assumption that at the time of the demolition the lease agreement of October 6, 1949, was a valid and valuable lease, and that the demolition was not necessary in order for taxpayer to secure the benefits of that lease. In this view, the demolition was a casual event, similar to the sale or abandonment of minor portions of railroad property (Br. 29-32) involved in the railway cases cited by taxpayer (*Commissioner* v. *Providence, W. & B. R. Co.,* 74 F. 2d 714 (C. A. 2d); *Terre Haute Electric Co.* v. *Commissioner,* 96 F. 2d 383 (C. A. 7th); *Mississippi River & Bonne Terre Railway* v. *Commissioner,* 39 B. T. A. 995).

In the present case, however, the original lease was solely for the Tivoli Theatre Building. Both parties intended at the time of the lease that the building be used as a garage and solely for that purpose. (R. 134.) In fact, taxpayer's witness, who conducted the negotiations, referred to it as "a lease for the reconstruction of the building into a five-story garage." (R. 114.) The lease provided for approval by taxpayer of the plans for alteration of the building for that purpose (R. 39) and taxpayer approved the plans (R. 117-120, 124). After the City and County of San Francisco refused to approve the plans, both parties recognized that it was impossible to carry out the lease according to its intention. (R. 123.)

At that point, both legally and practically, the lease was of doubtful value to the lessor. The entire purpose of the lease, to both parties, had been frustrated. It was doubtful whether it was enforceable when it had become impossible to use the premises for the purposes contemplated. Furthermore, as a practical matter, it was unlikely that the lessor could collect more than the $10,000 guarantee by Hertz, Marofsky, the lessee, being dependent on Hertz for funds with which to carry on the enterprise (R. 129) and Hertz's limited guarantee being an essential part of the arrangement.

Under these circumstances the agreement of April 24, 1950, viewed in its aspect as a lease, was both a different and a more valuable lease. It contained a recognition by the lessee of his obligation to pay the rentals even after the purpose of the original lease had become impossible; it provided for an additional lease deposit of $25,000; it contained a new subject matter, not the lease of the building for garage purposes, which had turned out to be impossible, but the lease of the premises for ground level parking; it permitted and later required the lessee to bear the expense of demolishing the building. As set out in the formal agreement of February 23, 1951 (R. 55-80), which set forth the terms of the agreement of April 24, 1950 (R. 55), the lessee was to demolish the building immediately and might use the premises as a parking lot (R. 62). The court below was on sound ground in holding that the lease was founded upon both the October 6, 1949 and April 24, 1950, agreements. (R. 98.) Even under the original agreement the term of the lease was not to begin until May 1, 1950. (R. 31.) When the term commenced the lease had become one for a parking lot, and not for a garage. Demolition of the building was necessary

for that lease. The facts here clearly call for the application of the rule that no loss is sustained on the demolition of a building for the purposes of securing a lease.

Taxpayer further argues (Br. 36-37) that, assuming for this purpose that the agreement of April 24, 1950, is a new lease secured by granting permission to demolish the building, there is nevertheless a loss sustained if the building was in fact worthless at the time, although not if the building had value. In support of this argument taxpayer cites a dictum in *Smith Real Estate Co.* v. *Page,* 67 F. 2d 462 (C. A. 1st). We submit that the distinction there drawn is unsound and ignores the reason why demolition losses are not allowed in this situation. As the cases cited in Point I above hold, a loss is not allowed because it is not in fact sustained where it is compensated for by a valuable lease, which is regarded as a substitution of one asset for another. That substitution occurs regardless of the value of the original asset. Or, to phrase it differently, no loss has yet been sustained because the demolition for the purpose of obtaining a lease is not a closed and completed transaction. If the transfer of buildings to a lessee, to be demolished and replaced, is not a step which fixes a loss for tax purposes in the case of buildings with an actual value, as the court in the *Smith Real Estate Co.* case held, there is no reason why the same transfer should fix a loss in the case of buildings with no actual value.

In the present case also, no loss was sustained. Taxpayer started with an asset with a basis of $132,284.42, regardless of its actual market value. It ended with another asset of value, a lease calling for total payments of $420,000, and requiring the lessee to assume certain additional expenses, in razing the building, to make the

parcel more useful and productive. There was no event fixing a loss, and no uncompensated loss was sustained.

CONCLUSION

The decision of the court below is correct and should be affirmed.

Respectfully submitted,

Charles K. Rice,
Acting Assistant Attorney General.
Lee A. Jackson,
David O. Walter,
Attorneys,
Department of Justice,
Washington 25, D. C.

February, 1956.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1956 375646 980